COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Request for Comments on the Procurement of Default Service Power Supply for Residential and Small Commercial and Industrial Customers	)))))	D.T.E. 04 -115

INITIAL COMMENTS AND ANSWERS OF STRATEGIC ENERGY

INTRODUCTION

Strategic Energy, L.L.C., ("Strategic") is a Competitive Supplier active in Massachusetts and nine other states. Strategic competes not-only against other Competitive Electric Suppliers, but also against the utility offer. Therefore, Strategic has substantial interest in any changes to the nature and design of Default Service. Strategic submits the following comments in response to the questions posed by the Department of Telecommunications and Energy the above-captioned matter.

DEFAULT SERVICE POWER SUPPLY OPTIONS

Massachusetts is exiting a transitional period when most customers were provided an option to stay on Standard Offer Service ("SOS") rates until February 28, 2005. As there was no return to service option, customers had a non-price incentive to stay with the utility. Default Service ("DS") customers have always had a return to service option, and therefore have been more willing to shop for competitive supply. More load is currently served by Competitive Suppliers than Default Service, albeit competitive supply is weighted toward the largest customer classes[1]. However, with the expiration of the SOS Option, many smaller customers will have more incentive to shop. It also becomes easier for Competitive Suppliers to market when all utility customers are receiving Default Service. No longer will suppliers have to sift through customer data to determine who is a SOS customer and who is DS – and this is particularly crucial for mass marketing.

While the Department's inquiry in the present proceeding is into the term and structure of wholesale procurement for default pricing for mass-market customers, Strategic believes it is appropriate to restate its vision for an end-state to place its replies in proper context. Fundamentally, Strategic remains committed to same vision articulated by the "Competitive Suppliers" in 2002:

> First, default service prices must include all of the costs of providing default service. This includes both all generation costs and all retailing costs. Providing competitive electric service to customers involves more than wholesale "generation." Competitive service involves all aspects of retail electric supply. Hiding some of these costs in the distribution charge is misleading and may lead customers to make the wrong choices. Competition has invariably failed in jurisdictions that have hidden supply and retailing costs in distribution charges. Full implementation of this principle will require unbundling, and removal of all retail electric supply costs from distribution rates.
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> Second, the utility must exit the role of default service provider. Competition will not fully develop, and may not develop at all for small customers, as long as the utility remains in this role. Instead, default service should be provided by competitive retail suppliers. Implementation of this principle will require a retail auction or similar mechanism to move customers to competitive default service supplier
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> Third, in the end-state, billing should be performed by competitive retail suppliers rather than utilities. The bill is the primary means of communication with small customers; it should be provided by the competitive firm, not the monopoly. In light of current statutory limitations, the utilities should continue to perform billing for the short term. However, they should do so as a service to suppliers, including default providers, and should charge for that service pursuant to Department-approved tariffs[2].

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[1] Massachusetts DOER, Electric Customer Migration Data

[2] *Initial Comments of the Competitive Retail Suppliers*, DTE 02-40 Investigation into the Provision of Default Service, August 9, 2002

While the Department ordered the unbundling of some retail generation costs from DS rates in DTE 02-40-B, customer care, billing and other costs remain bundled with the utility distribution rate. By way of comparison, in 2004 the New York Public Service Commission issued its Statement of Policy on Unbundling, and appropriately Ordered distribution utilities to allocate a portion of their billing and customer service costs using an Embedded Cost of Service methodology that provides a better long-run cost of service view of these retail costs than the short-run marginal costs savings that are often cited as a reason not to bother fully unbundling rates. In response, Con Edison will offer a program entitled "Market Match" in which a supplier can offer electric customers who enroll under utility consolidated billing a seven percent discount from the Energy Shopping Price for a two-billing cycle introductory period. Customers enrolled by Con Edison through this Program are not permitted to select a specific supplier, but are randomly assigned. Strategic recommends that the Department consider a similar review of rates in Massachusetts and the possible adoption of a plan similar to Con Edison's.

While a proper unbundling would provide better price transparency for consumers and move the competitive market forward, the solution to properly administering the Default Service program is to outsource this function to an entity other than the distribution utility, as has been done in Georgia, Texas and the United Kingdom. Once unbundled in this manner, there is little question whether the price is reflective of the true cost of service.

COMMENTS ON ISSUES PRESENTED BY THE DEPARTMENT

1. Would smaller customers be better served if power supply for default service is procured using a portfolio of more than two solicitations? Please discuss the advantages and disadvantages of increasing the number of solicitations used to procure default service supply.

When the Massachusetts retail electricity market was restructured, the underlying confidence was that market suppliers would compete with each other for customers by eliminating inefficiencies and offering creative products. This is exactly what is happening, albeit at a somewhat slower pace than what was initially envisioned for the smaller customers. From experience, we know that the most common products offered by suppliers are tied to contracts of varying lengths. Absent the offer of additional incentives to enter a supply deal, customers will generally choose the contract length offered that yields the best possible price for their generation supply.

Using pricing models, retail suppliers, calculate pricing for different contract lengths (terms) while taking into account customer type, usage patterns, seasonal differentiation and a host of other determinants. These calculations are performed time and time again throughout the year and take into account the constantly fluctuating price of energy in the wholesale market. Conversely, the current Default Service procurement process captures the prevailing forward price at a point in time, for two six-month procurements, but still manages a fair representation of market pricing without being too intrusive on the developing competitive environment. A good balance is struck between giving smaller customers some price stability under which they can live and operate, and keeping pricing in approximate step with the realities of the cost of power. Any strategy beyond what the current Default Service procurement process employs is best left to the competitive suppliers whose main objective is to give customers what they want, be it the lowest cost, long-term price stability or some combination of the two.

It is equally important to bear in mind that there is no guarantee that more frequent or multiple solicitations will yield a lower price. Again, this is a risk best managed by suppliers, rather than thrust upon customers.

An additional point worth noting is that too zealous an approach to locking in longer term prices will also produce the unwanted side effect of distorting price signals to customers by keeping prices flat during high usage periods. This is undesirable from a reliability standpoint since demand response to price signals is poised to become a valuable tool. Acknowledging that smaller customers have not yet been fully educated to be price responsive, it still seems counterproductive to put rules in place that actually support maintaining the status quo.

2. Would smaller customers be better served if power supply for default service was procured for a term longer than twelve months? Please discuss the advantages and disadvantages of using supply terms greater than twelve months.

In particular, please discuss:

a. whether longer contract terms are likely to produce lower prices,

b. how such an approach would affect price certainty and market efficiency, and

c. how such an approach could be tailored to accommodate customer migration to competitive supply.

As previously discussed, it is Strategic's firm opinion that a Default Service that locks in pricing for too long a period at the very least carries a great risk of stymieing competition. This would only occur if the procurement took place when the market just so happened to be at its lowest pricing point of the year. Not only is there little chance of this happening, even the most unsophisticated of suppliers would not use this strategy since timing the market is nearly impossible and carries great risks.

A worse case, and more likely scenario, would be if the procurement period fell during a period with high forward prices. Default Service would end up locking in elevated prices for an extended period of time, and customers would be forced to pay higher rates if they couldn't find or were not comfortable signing a contract with a competitive supplier. Of course, this would give price stability and certainty, but also the certainty of no cost relief for the balance of the Default Service period.

Assuming that customers would then migrate from a higher priced Default Service because power prices decreased and competitive suppliers could beat the rate, the supplier of Default Service would be left holding the bag for the remainder of the price period. No longer serving those customers, the Default Service supplier would still possess high-priced power in a lower priced environment and would likely be forced to sell at a loss in the wholesale market. The only way to protect a supplier from migration risk for such a long-term obligation is through "keep whole" provisions such as exit fees or volume risk premiums that will be imbedded in the initial price. Both of these techniques have proven to be disastrous barriers in other retail open access markets.

3. Would smaller customers be better served if power supply for default service was procured on a statewide basis? Please discuss the advantages and disadvantages of using a statewide approach to default service procurement.

Strategic can see no significant advantages and only a few disadvantages to statewide RFP, as opposed to the current utility-by-utility process. However, for reasons of market power risk, we suggest that the Department be cautious about allowing only one or two suppliers to monopolize the Default supply service if it is decided that Default Service will be procured on a statewide basis.

Additionally, the Department should consider the possible ramifications of procuring power for all Default Service in the state on the same day. In purchasing all of the power at the same time, the opportunity to blend at all any market increases or decreases throughout the year is forgone, and market liquidity for some period of time (the time it takes to complete the RFP process) will be somewhat stifled. Strategic concludes that a statewide RFP is likely not beneficial.

4. Would smaller customers be better served if power supply for default service was procured using an auction process (e.g., descending clock) rather than through requests for proposals? Please discuss the advantages and disadvantages of using an

auction process to procure default service. In particular, please discuss whether using an auction is likely to produce lower default service prices.

Whether or not an auction would produce lower prices than an RFP is difficult to assess. Again, the single largest determinant of a pricing outcome is the timing of the solicitation. Both an auction and an RFP are competitive processes that give the competing parties equal incentives to offer the lowest price. Certainly, different states have had success using either option. However, it might not be worth the expense that would be incurred by the participants and/or customers in order to go through the extensive design, development, approval and implementation normally associated with putting an auction process in place.

5. Although the term "default service" is statutory, G.L. c. 164, § 1, it has confused some customers because of its unintended suggestion of nonfeasance in performing a legal or contractual obligation. Is there some better or more descriptive term that ought to be used by the distribution companies on and after March 2005?

Leaving aside the issue of whether renaming Default Service would be consistent with Restructuring Act, the Department should consider not only consumer confusion caused by multiple interpretations of the term "default" but also the confusion that could be created by alternatives. As defined in G.L. c. 164 (the "Act"), Default Service, is the generation supply a customer receives for having failed to procure electricity, regardless of the reason.

As defined in the Merriam-Webster Dictionary, default may be the "failure to do something required by duty or law," which, it could be argued, describes the nature of Default Service as defined in Act. An alternative Merriam-Webster definition is "a selection automatically used by a computer program in the absence of a choice made by the user," which accurately describes the process by which customers are assigned to Default Service. Therefore, the word "Default," as used in the term Default Service, is neither inaccurate nor misleading.

If consumers too often associate "default" with still another definition: "to fail to pay financial debts," and this is judged by the Department to be injurious, then the Department should propose an alternative that better defines Default Service, and not one that simply makes customers feel at ease about not choosing a supplier. More importantly, the Department should not consider alternate names for Default Service that imply it is less expense, safer, or better than competitive offerings.

One alternative that the Department should consider that accurately describes the nature of Default service is "Last Resort Service," the term for Default Service used in Rhode Island. This term plainly describes the service being provided the consumer, informing them that they have not made a choice of providers, without implying that the customer has financially defaulted.

CONCLUSION

Strategic Energy respectfully requests that the Department adopt the recommendations set forth above.

Respectfully submitted,

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